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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1979

No. 79-509

EXXON CORPORATION,
Appellant,

v.

WISCONSIN DEPARTMENT OF REVENUE,

Appellee.

On Appeal from the
Supreme Court of Wisconsin

BRIEF OF APPELLEE

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BRIEF OF APPELLEE

QUESTIONS PRESENTED

1. Whether the State of Wisconsin's treatment of Exxon as a unitary business has rendered Wis. Stats. § 71.07(2) invalid under the Due Process Clause of the Fourteenth Amendment to the United States Constitution.

2. Whether the State of Wisconsin, by subjecting income resulting from Exxon's exploration and production operations to apportionment under its formula for

taxing unitary businesses, has construed Wis. Stats. § 71.07(1) and (2) so as to render the statutes invalid under the Due Process Clause of the Fourteenth Amendment to the United States Constitution.

3. Whether the State of Wisconsin, by subjecting income resulting from Exxon's exploration and production operations to apportionment under its formula for taxing unitary businesses, has construed Wis. Stats. § 71.07(1) and (2) so as to render the statutes invalid under the Commerce Clause of the United States Constitution.

STATEMENT OF THE CASE

A. *Proceedings Below.*

This case was commenced by Exxon when it appealed Appellee's denial of its application for abatement of an additional franchise tax assessment for the years 1965 through 1968 to the Wisconsin Tax Appeals Commission. (JS App. 81). The Tax Appeals Commission found that:

1. Appellant's three main functional operations were each separate unitary businesses;

2. Appellee's apportionment formula improperly included income from sources outside Wisconsin;

3. An apportionment formula apportioning only income earned by Appellant from its marketing function would be proper; and

4. Appellee's assessment subjected part of Appellant's income to multiple taxation. (JS App. 66).

The Appellee appealed the Commission's decision to the Circuit Court for Dane County, Wisconsin. By decision and order entered on January 31, 1977 (JS App. 34-65), that court found that Exxon was a unitary business and that its total income was subject to apportionment by Wisconsin. That court also found that all of Exxon's income from exploration and production should be excluded from apportionment as situs income and that some of Exxon's exploration and production income was being subjected to double taxation.

The circuit court decision was appealed to the Wisconsin Supreme Court on cross-appeals. Exxon appealed the unitary business issue and Appellee appealed the situs income issue.

The Wisconsin Supreme Court affirmed the circuit court's decision on the unitary business issue, and reversed the circuit court's decision on the situs income issue. (JS App. 1).

B. *Unitary Aspects Of Exxon's Corporate Structure.*

The facts in this and the preceding section are in addition to the facts presented in Exxon's brief.

Exxon's corporate-wide activities during the years at issue were coordinated by various departments under one corporate entity in order to assure a stable outlet for its products and provide for some assurance that the risk of disruptions in Exxon's refining operations was minimized under the supply and demand imbalances which occur from time to time. (A. 224-25).

Exxon's corporate structure included a segment referred to as "Coordination and Services Management"

which was responsible for providing specialized corporate services for Exxon's overall operation. This corporate segment was composed of numerous individual departments, each of which provided certain specialized services for the total corporate entity. (A. 188-89).

Thus, the corporate planning department provided long-range company planning and developed company strategies. (A. 189). The secretary's department maintained the official corporate records and was responsible for executive compensation and executive development. (A. 189).

The supply department acquired products which the marketing department sold to the public. (A. 189, 339, 344). It also had planning responsibilities involving the expansion of refineries, the determination of future supplies, the appraisal of the market conditions and the development of pricing strategies and pricing changes. (A. 297).

The treasury department was responsible for all the financial resources of the company as well as the development of company financial policy. It was also responsible for the development of plans for the appropriate financing of company activities and for supplying advice with regard to proposed investments. (A. 190). The controller's department was in charge of the company's books of account and responsible for the overall maintenance of the company's accounting systems. (A. 190). The tax department was responsible for tax administration and for providing tax advice to other departments while the law department was responsible for providing legal counsel to the various management groups. (A. 190-91, 363).

Exxon had, in addition, a public relations department for the promotion of the general public's understanding of the company's character, goals and performance (A. 191), a government relations department for the coordination of company relations with the federal government and the State of Texas (A. 191), an employee relations department responsible for providing a competent and able work force within the company (A. 191-92), a general services department responsible for providing other departments with office facilities and services (A. 192), and a medical department responsible for advising the company on employee health and providing employees with professional medical assistance and advice. (A. 192).

C. Centralized Control Over Exxon's Wisconsin Marketing Operations.

Exxon's out-of-state activities directly affected its in-state marketing operations. Thus, during the audit period, motor oils, greases and other packaged products which were manufactured by Exxon from raw materials including its own crude, were shipped into Wisconsin from the company's central warehouse facilities to be sold at retail. (A. 275, 288). Tires, batteries, and accessories were centrally purchased by Exxon's purchasing office in Houston and shipped into Wisconsin for retail sale. (A. 257-58). Gasoline sold at retail in Wisconsin during the period was obtained from another oil company through an exchange agreement negotiated and executed by the supply department in Houston. (A. 257, 349). Such exchange agreements reduce transportation costs from production point to marketing area. (A. 355-57). Additives were added by Exxon to the gasoline shipped into Wisconsin in order to assure it

complied with company-wide quality standards. (A. 355-57).

Exxon had a centralized advertising staff located in Houston which created advertising materials for use nationwide. As the company's 1965 Annual Report indicates, Exxon's "Tiger in the Tank" campaign resulted in a marked increase in retail sales. (A. 257, Exhibit 11-5 at 7 - *See* record). Exxon also employed uniform brand names and uniform packaging for its gasoline and other products. Service stations were uniformly designed and developed by the engineering staff in Houston. (A. 250). A uniform credit card system administered from Houston was used in all states. (A. 249). Finally, Exxon had a company-wide self-insurance plan which resulted in substantial savings and which covered risks up to ten million dollars. (A. 210).

The home office in Houston also developed pricing policy (A. 255), drafted uniform selling forms and contracts (A. 255), drafted product guarantees or warranties (A. 255), established sales districts (A. 255-56), located new service stations (A. 256), approved operating budgets (A. 256), invested funds and borrowed money (A. 258), approved salary increases (A. 263), and developed retirement as well as health and accident insurance plans. (A. 263-65).

SUMMARY OF ARGUMENT

I. The determination by the Wisconsin Supreme Court that Exxon's operations in Wisconsin constituted an integral part of a unitary business is amply supported by the evidence in the record. While the Wisconsin court properly held that the unitary issue presented a question of law, its decision on the unitary issue was made only after reviewing and considering a series of undisputed factual determinations. The testimony of one of Exxon's senior vice presidents demonstrated that Exxon's unity of ownership and management was directly related to the maintenance of corporate-wide profits and thereby satisfied the test formulated by this Court in *Butler Bros. v. McColgan*, 315 U.S. 501 (1942).

As a unitary business Exxon cannot through separate functional accounting attempt to impeach Wisconsin's three-factor apportionment formula, since separate accounting is incompatible with the concept of the unitary business. In addition, an extension of the separate accounting *dicta* in *Moorman Manufacturing Co. v. Blair*, 437 U.S. 267 (1978), to states which impose corporate income taxes on the basis of a three-factor formula would be in clear conflict with the *Butler Brothers* decision.

The "dependent upon or contributory to" definition of "unitary" used by the Wisconsin court is consistent with both the "unity of ownership and management" test found in *Butler Brothers* and prevailing case authority. The "necessary" test proposed by Exxon has not been accepted by this Court or any other jurisdiction. Such a test would render the unitary concept meaningless.

II. Income generated by Exxon's exploration and production activities is unitary business income and is, therefore, properly subject to apportionment under Wisconsin's three-factor formula. Exxon cannot, through separate functional accounting, prove that Wisconsin is taxing extraterritorial values. Exxon's attempt to compute divisional income by placing a value on internal transfers of crude oil is not consistent with the principle that a unitary business earns no profits until actual sales of its products are made. *Bass, Ratcliff & Gretton v. State Tax Commission*, 266 U.S. 271 (1924).

In any event, Exxon's separate accounting analysis is incomplete since it fails to account for a single dollar of income on a geographical basis. Although under the unitary concept income from a unitary business cannot be rationally attributed to particular functions or precisely determined according to taxing jurisdictions, if a taxpayer is going to attempt to so attribute such income, it must account for 100% of its total net income.

Accordingly, Wisconsin is not taxing extraterritorial values in contravention of the Due Process Clause when it subjects a portion of the income generated from Exxon's exploration and production activities to apportionment; it is taxing income from a unitary business doing business in the state.

III. Exxon has failed to show the existence of any constitutionally prohibited multiple taxation. Its assertion that the Constitution prohibits even the risk or possibility of multiple taxation is not the law. In *Moorman* it was pointed out that the Commerce Clause does not prohibit some overlap in the computation of taxable income.

The record does not support Exxon's multiple taxation argument. Wisconsin has not, by including a portion of the income generated from Exxon's exploration and production operations in its apportionment formula, created any risk of multiple taxation in contravention of the Commerce Clause.

ARGUMENT

I. The Wisconsin Supreme Court's Finding That Exxon's Operations In Wisconsin Were An Integral Part Of A Unitary Business Within The Meaning Of Wis. Stats. § 71.07(2) Is Not Constitutionally Prohibited By The Due Process Clause Of The Fourteenth Amendment To The United States Constitution.

A. Only after considering the facts in the record did the Wisconsin Supreme Court determine that as a matter of law Exxon's Wisconsin operations were an integral part of a unitary business.

This Court has long recognized the concept of the unitary business. *Butler Bros. v. McColgan*, 315 U.S. 501 (1942). In concluding that California could properly treat a wholesale dry goods and general merchandise business as a unitary business the Court stated:

> At least since Adams Express Co. v. Ohio State Auditor, 165 U.S. 194, 17 S.Ct. 305, 41 L.Ed. 683, this Court has recognized that unity of use and management of a business which is scattered through several States may be considered when a State attempts to impose a tax on an apportionment basis. As stated in Hans Rees' Sons, Inc., v. North Carolina, supra, 283 U.S.

> page 133, 51 S.Ct. page 389, 75 L.Ed. 879, "•••the enterprise of a corporation which manufactures and sells its manufactured product is ordinarily a unitary business, and all the factors in that enterprise are essential to the realization of profits." (315 U.S. at 508).

The term unitary business has been variously defined. The definition relied on by the Wisconsin Supreme Court, as borrowed from the text authority of **Altman & Keesling**, *Allocations of Income In State Taxation*, (2d ed.), p. 101, is whether " 'the operation of the portion of the business within the state is dependent upon or contributory to the operation of the business outside the state.' " (90 Wis. 2d at 711, 281 N.W.2d at 100). The test relied on by this Court in *Butler Brothers* is whether there exists a unity of ownership and management. (315 U.S. at 508).

Using either approach, the holding of the Wisconsin Supreme Court, that Exxon was a single unitary business, is amply supported by the record. The Wisconsin Supreme Court properly determined that the issue of whether Exxon's operations constituted a unitary business presented a question of law. It did not, as suggested by Appellant, determine that Exxon was inherently a unitary business. It reviewed the facts as presented in the record before the Wisconsin Tax Appeals Commission. Thus, in arriving at its determination that Exxon's business was unitary the Wisconsin court considered and relied on a series of undisputed factual determinations. (90 Wis. 2d at 714-18, 281 N.W.2d at 102-04).

The court pointed out that while Exxon's corporate organization consisted of three parts referred to as corporate management, coordination and service management, and operations management, the court was concerned only with operations management, which was the part responsible for directing the operating activities of the individual functional segments of the company.

The three major individual functional segments, or departments, of operations management were Exploration and Production, Refining, and Marketing. Each of these departments had its own management responsible for conducting the operation of the department and a separate profit center where expense and revenue were recorded to determine a profit for that department. The company considered each department a separate investment center.

Company policy required the transfer of products and raw materials between departments to be based upon competitive wholesale market prices. Inter-departmental transfers were accounted for either at posted industry prices, or at prices determined through "arm's length" negotiations between representatives from the various departments. These prices were recorded in order to determine the performance of each department.

Exxon manufactured and produced motor oils, greases, and other packaged products outside of Wisconsin, and shipped them into the state for sale. It purchased tires, batteries, and accessories through its central purchasing office, and shipped them into Wisconsin for sale.

It also transported into Wisconsin gasoline and fuel oil obtained through an exchange agreement with another oil company in order to reduce the cost of transporting gasoline and fuel oil from the source of production to the point of sale.

The Wisconsin Supreme Court pointed out that Exxon has a centrally administered credit card system used nationwide; that it promotes its products by uniform packaging and brand names; that it uses centrally designed promotional display equipment; and that its overall distribution plan is developed at its central office. It also pointed out that key employees are frequently transferred from one department to another.

The court, while indicating that Exxon had no production or refining functions in Wisconsin, stated:

> What emerges from this pattern of organization is that Humble's production and refining functions depended upon the marketing operation to provide an outlet for its products. Wisconsin was a part of Humble's marketing system. In a high capital investment industry such as the petroleum industry, the existence of a stable and assured marketing system is important for the full utilization of refining capacity. This was the testimony of a top Exxon executive who admitted that the profits of the overall corporation depend on the profits of each of the individual functional segments. (90 Wis. 2d at 718, 281 N.W.2d at 104).

The testimony the Wisconsin Supreme Court was referring to came from Oral Luper, a senior vice president of Exxon, wherein he explained why the separate corporate departments were organized under one corporate entity.

> ". . . [I]n any industry which is highly capital intensive, such as the petroleum industry, the fixed operating costs are highly relative to total operating costs, and for this reason the profitability of such an industry is very sensitive and directly related to the full utilization of the capacity of the facilities.
>
> "So, in the case of the petroleum industry . . . where you have high capital investments in refineries, the existence of an assured supply of raw materials and crude is important and the assured and stable outlet for products is important, and therefore when there are -- when these segments are under a single corporate entity, it provides for some assurance that the risk of disruptions in refining operations are minimized due to supply and demand imbalances that may occur from time to time." (90 Wis. 2d at 716, 281 N.W.2d at 103; A. 224-25).

Thus, Exxon's own witness demonstrated that unity of ownership and management is directly related to the

maintenance of corporate-wide profits and thereby supplied the very basis for the wide acceptance, for state income tax purposes, of the unitary business concept. In so doing Exxon's witness also satisfied the test formulated by this Court in *Butler Brothers*.

As pointed out in Appellee's Motion to Dismiss or Affirm, the Oregon Tax Court, in a case involving the same corporation and nearly identical facts, held that Exxon's activities in Oregon were part of a unitary business although its Oregon operations dealt almost exclusively with marketing. *Humble Oil & Refining Company v. Dept. of Revenue*, 4 OTR 284 (1971). Although Exxon suggests that evidence exists in the Wisconsin case that did not exist in the Oregon case, it appears that the essential facts relied on by the Oregon Tax Court are present in the record before the Wisconsin Tax Appeals Commission.[1]

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1 The Oregon court pointed out that:

> Humble Oil & Refining Company is a large vertically integrated corporation engaged nationwide in all phases of the petroleum industry, from discovery through production and manufacture to marketing. It has unity of ownership, operations, management, control and products; and strong centralized credit, purchasing, advertising, accounting and legal services. All segments of plaintiff's business have a great deal in common and contribute to and are dependent upon each other. The plaintiff is actually a single interrelated unitary business operation. The component parts, including those in Oregon, are too closely connected and necessary to each other to be considered as independent units.

(footnote 1 continued on next page)

The Wisconsin Supreme Court's determination that Exxon's activities in Wisconsin were an integral part of a unitary business was based on the facts in the record before it. It did not make a *per se* determination as claimed by Appellant. The Wisconsin court's determination on the unitary issue is amply supported by the facts and consistent with *Butler Brothers*. It should be affirmed by this Court.

B. *Exxon, as a unitary business, cannot through separate functional accounting prove its claim that Wisconsin is taxing extraterritorial income.*

(footnote 1 continued)

> Producing in one state and selling in another depends upon a multitude of interdependent operations, and although the petroleum Humble sold in Oregon was not its own production but that of a third party, the sales nevertheless were made possible by the company's own production. If plaintiff wasn't producing it wouldn't be selling, and what plaintiff did in Oregon was not due solely to conditions here, but was dependent upon the market elsewhere and upon plaintiff's production and manufacturing elsewhere. The marketing in Oregon was an integrated part of plaintiff's nationwide business and undoubtedly was beneficial to the corporation as a whole. It was not a completely separate, independent or local endeavor. Plaintiff's production and refining conform to the demands of the nationwide market, and the court believes plaintiff expanded into Oregon to increase demand for its products so that it could increase production and refining and thus increase profits and its stature in the industry. (4 OTR 292-93).

Separate accounting is incompatible with the concept of a single unitary business. Income from a unitary business results from the operation of that business as a single integrated unit. By its very nature that income cannot be attributed to a single activity or group of activities engaged in by such a unitary business. It must be attributed to the business as a whole.

The basic principle underlying the formula apportionment approach to the taxation of income from a unitary business was recognized by this Court in *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920). In *Underwood* the State of Connecticut applied its apportionment formula to the entire net income of the taxpayer. The formula attributed 47 percent of taxpayer's taxable income, or $629,688.05, to Connecticut. Although the taxpayer attempted to show, presumably by separate accounting, that only $42,942.18 of its income was earned in Connecticut, this Court held that such showing did not support taxpayer's objection, saying:

> The profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with sale in other States. In this it was typical of a large part of the manufacturing business conducted in the State. The legislature in attempting to put upon this business its fair share of the burden of taxation was faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders. It, therefore, adopted a

> method of apportionment which, for all that appears in this record, reached, and was meant to reach, only the profits earned within the State. (254 U.S. at 120-21).

The taxpayer in *Butler Brothers* also sought to establish by separate accounting that it suffered losses in California and, therefore, California's apportionment formula which assigned profits to that state was unreasonable and invalid. This Court held that taxpayer's separate accounting practices did not impeach the formula applied by California, stating:

> Accounting practices for income statements may vary considerably according to the problem at hand. Sanders, Hatfield & Moore. A Statement of Accounting Principles (1938), p. 26. A particular accounting system, though useful or necessary as a business aid, may not fit the different requirements when a State seeks to tax values created by business within its borders. Cf. Hamilton, Cost as a Standard for Price, 4 Law & Contemporary Problems 321. That may be due to the fact, as stated by Mr. Justice Brandeis in Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113, 121, 41 S.Ct. 45, 47, 65 L.Ed. 165, that a State in attempting

> to place upon a business extending into several States "its fair share of the burden of taxation" is "faced with the impossibility of allocating specifically the profits earned by the processes conducted within its borders." Furthermore, the particular system used may not reveal the facts basic to the State's determination. Bass, Ratcliff & Gretton, Ltd., v. State Tax Commission, supra, 266 U.S. page 283, 45 S.Ct. page 84, 69 L.Ed. 282. In either aspect of the matter the results of the accounting system employed by appellant do not impeach the validity or propriety of the formula which California has applied here. (315 U.S. at 507-08).

In support of its separate accounting approach Exxon relies on *dicta* from this Court's recent opinion in *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978), to the effect that a separate accounting analysis might have been used to show Iowa's single-factor sales formula was taxing income the source of which was extraterritorial to that state. In sustaining the Iowa tax this Court held that, "Iowa is not constitutionally prohibited from requiring taxpayers to prove that application of the single-factor formula has produced arbitrary results in a particular case." (437 U.S. at 281).

Although the *Moorman dicta* appears to support the claim that separate accounting may be used to prove that a single-factor sales formula has produced arbitrary results in a particular case, that *dicta* should not be extended to apply to the three-factor formula approach. The single-factor formula approach is inherently more suspect than the three-factor approach.[2] Iowa's single factor sales formula, by imposing a tax solely on the basis of sales, fails to recognize that income from a unitary business results from the business as a whole and not from a single factor such as sales. As this Court pointed out in *Underwood Typewriter, supra*, "[t]he profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with sale in other states." (254 U.S. at 120).[3] Clearly a single-factor formula whether based on sales or property does not consider the nature of the unitary business and could well produce a distorted result. See, *Hans Rees' Sons v. North Carolina*, 283 U.S. 123 (1931). The single-factor sales formula is, in addition, totally out of harmony with the three-factor formula approach adopted nearly unanimously by other States which impose corporate income taxes.[4]

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2 Justice Blackman in his dissent in *Moorman* referred to single-factor formulas as "relics of the early days of state income taxation." (437 U.S. at 282).

3 It should be noted that the taxpayer in *Moorman* attempted to compute its tax based on a three-factor formula; however, this approach was rejected by Iowa's Director of Revenue. (437 U.S. at 270-71).

4 Justice Powell's dissent in *Moorman* points out that 44 of the 45 other states which impose corporate income taxes use a three-factor formula approach. (437 U.S. at 283).

The rationale for allowing a single-factor sales formula to be impeached by a separate accounting analysis does not apply to the three-factor formula approach. The three-factor formula does recognize that income from a unitary business results from the business as a whole and not from its parts.[5] Separate accounting is conceptually incompatible with the three-factor formula approach to taxation of income from a unitary business and cannot, as indicated by this Court in *Butler Brothers*, be used to impeach the validity of such a formula. While separate functional accounting may be useful as business aid,[6] it is, as pointed out by the Wisconsin Supreme Court, "incompatible with the

> 'very essence of formulary apportionment, namely, that where there are integrated, interdependent steps in the economic process carried on by a business enterprise, there is no logical or viable method for accurately separating out the profit attributable to one step in the economic process from other steps.

---

5 As stated in Parts II and III of this brief, Exxon's separate accounting analysis does not account for any of its income on a geographical basis. It is submitted that a valid separate accounting analysis must account for 100% of a taxpayer's income both on a functional and a geographical basis or it is an incomplete analysis.

6 Mr. Ernest L. Wehner, a CPA with the firm of Arthur Anderson & Company and one of Exxon's witnesses, testified that it was his experience that all companies use a form of functional profitability independence accounting to measure the performance of their personnel and investment. (A. 436-37). Thus, if Exxon is permitted to impeach Wisconsin's or any other state's three-factor formula through separate functional accounting all unitary businesses will presumably be able to do likewise.

It is for that reason that the States have resorted to formulary apportionment--unrefined and approximate though the results may be--in the case of an enterprise engaged in manufacturing and selling, where the activities take place in more than one State. Essentially, the same inherent difficulties are present in seeking to divide the profits of an oil company, where producing, manufacturing and marketing take place in different States." Hellerstein, *State And Local Taxation*, (3rd Edition, 1969), p. 400.' (90 Wis. 2d at 726, 281 N.W. 2d at 109).

An extension of the separate accounting *dicta* in *Moorman* to states which impose corporate income taxes on the basis of a three-factor formula would be in clear conflict with the *Butler Brothers* decision and irreconcilable with the unitary business concept.

C. *The Wisconsin Supreme Court's determination that a business is "unitary" if its operations within the state are "dependent upon or contributory to" its operations outside the state is consistent with Butler Brothers and prevailing case authority.*

The Wisconsin court relied on the "dependent upon or contributory to" definition of "unitary" from the text authority of Altman & Keesling, *Allocation Of*

Income In State Taxation, (2d ed.), p. 101. This definition is equivalent to the unity of ownership and management test found in the *Butler Brothers* decision. Hence, in a recent case involving the same taxpayer, *Exxon Corp. v. South Carlolina Tax Com'n*, 258 S.E. 2d 93 (S.C. 1979), the South Carolina Supreme Court stated:

> The "unities" concept and the "contribution-dependence" test are by no means mutually exclusive. In the decision cited above, the courts have often applied both definitions in deciding whether or not a business is unitary in nature. The origins of both definitions may be traced to the *Butler Brothers* decision and the activities of a corporation which exhibit unity of ownership, management and operation have usually been found to be activities which are contributory or dependent upon one another. (258 S.E.2d at 95).

The South Carolina court specifically rejected the "necessary and essential" test proposed by Exxon as not in conformity with *Butler Brothers*. The court suggested that the contribution-dependence test as well as the unity of ownership and management test would become irrelevant if such a test were adopted.

The California Supreme Court has also rejected the "necessary and essential" test in favor of the contribution-dependence test. *Superior Oil Company v. Franchise Tax Board*, 60 Cal. 2d 406, 386 P.2d 33 (1963); *Edison California Stores v. McColgan*, 30 Cal.2d 472, 183 P.2d

16 (1947). Other jurisdictions have done the same. *Zale-Salem, Inc. v. State Tax Commission*, 237 Or. 261, 391 P.2d 601 (1964); *Crawford Mfg. Co. v. State Commission of Rev. & Tax*, 180 Kan. 352, 304 P.2d 504 (1956).

It is not surprising that Exxon has cited no authority for its proposal that a state should be able to apportion corporate income only when a taxpayer's in-state activity is "necessary" to one or more of the taxpayer's out-of-state functional operations. Such a "necessary" test is clearly not consistent with the *Butler Brothers* decision. The taxpayer in *Butler Brothers* maintained that its wholesale distributing house in California had no effect on its ability through centralized purchasing to obtain more favorable prices for its wholesale merchandise since it would be able to obtain the same favorable prices without the California wholesale house. This Court pointed out that there was no justification for singling out the California operation over any other and concluding that it made no "contribution" to taxpayer's total savings, saying:

> As aptly stated by the Supreme Court of California, "If the omission of the California sales would have no effect on the purchasing power, the omission of sales in an equal amount wherever made would likewise have no effect on the company's ability to purchase at a saving. Thus, by proceeding in turn from state to state, it could be shown that none of the sales in any of the states should be credited with the income resulting from the purchasing of goods in large quantities." (315 U.S. at 508-09).

Thus, this Court relied on a "contribution" rather than a "necessary" test when it recognized that while Butler Brothers' California operation may not have been necessary to taxpayer's total operation it clearly contributed to the same.

A test based on necessity would enable large multi-state corporations to argue, through a process of elimination similar to that employed by Butler Brothers, that none of its parts are necessary to the whole. Such a test would render the "unitary" concept meaningless.[7] The "necessary" test proposed by Exxon has not been adopted by this Court or any other jurisdiction. The "contribution-dependence" test adopted by the Wisconsin Supreme Court is in conformity with the *Butler Brothers* decision and with prevailing case authority.

II. Subjecting Income From Exxon's Exploration And Production Operations To Apportionment Does Not Violate The Due Process Clause Of The Fourteenth Amendment To The United States Constitution.

A. Wisconsin's treating a portion of Exxon's exploration and production income as income from a unitary business and subjecting that income to apportionment was proper.

In applying its apportionment formula to Exxon, the Appellee excluded from apportionable income any

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7 Thus, one can remove the links from a chain until there are but two left and still have a chain. Although each link contributes to the chain, only when two remain does any link become necessary.

income resulting from sales of crude oil to third parties at the well head. Appellee included in Exxon's apportionable income any income resulting from oil produced by Exxon and transferred by it to its refining operations.[8] Such apportionment was made pursuant to Wis. Stats. (1967) § 71.07(1) and (2), which provides, in pertinent part, as follows:

> (1) For the purposes of taxation income or loss from business, not requiring apportionment under sub. (2), (3) or (5), shall follow the situs of the business from which derived. Income or loss derived from rentals and royalties from real estate or tangible personal property, or from the operation of any farm, mine or quarry, or from the sale of real property or tangible personal property shall follow the situs of the property from which derived. . . .
>
> (2) Persons engaged in business within and without the state shall be taxed only on such income as is derived from business transacted and property located within the state. The amount of such income attributable to Wisconsin may be determined by an allocation and separate accounting thereof, when the business of such person within the state is not an integral part of a unitary business provided, however, that the department of taxation may permit an allocation and separate accounting in any case in which it is satisfied that the use of such method will properly reflect the income taxable by this state. In all cases in which allocation and separate accounting is not permissible, the determination shall be made in the following manner: There shall first be deducted from the total net income of the taxpayer such part thereof (less related expenses, if any) as follows the situs of the property or the residence of the recipient . . . .

8 The allocation was made by applying a so-called "barrel formula" to separate the crude oil sold to third parties at the well head from that transferred by Exxon to its refining operations. In view of the information available, the "barrel formula" was a reasonable method by which fungible, commingled goods could be separated. (A. 521). Exxon has not proposed an alternate formula or suggested that the "barrel formula" reached income which Wisconsin did not intend to tax.

Exxon contends that any income it has allocated under its separate accounting analysis to its exploration and production activities is situs income which is not subject to taxation under Wisconsin's three-factor formula. The Wisconsin Supreme Court, however, held otherwise saying that since Exxon was unitary the statute required apportionment of its business income. The court pointed out that crude oil produced by Exxon and transferred by it to its refining operations was part of the unitary stream of income and was, therefore, pursuant to Wis. Stats. § 71.07(1), properly apportionable. (90 Wis. 2d at 724). While Exxon appears to take issue with the construction given the statute by the Wisconsin Supreme Court, this Court has held that it will not interfere with a construction given a state statute by that state's highest court. *Gurley v. Rhoden*, 421 U.S. 200, 208 (1975).

Exxon further contends that the Wisconsin Supreme Court has rendered Wis. Stats. § 71.07(1) and (2), unconstitutional under the Due Process Clause because by its construction of the statutes it has taxed income resulting from Exxon's exploration and production activities which, according to Exxon, has "no rational relationship" to the State of Wisconsin.

The Appellee submits that income generated by Exxon's exploration and production activities is unitary business income and, as such, is properly subject to apportionment under Wisconsin's three-factor formula. The nexus requirement of *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967), and *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959), is satisfied by Exxon's extensive marketing activities in the state during the period in question. The *National Bellas Hess* and *Northwestern States* cases require only that the taxing state establish some minimum connection between it and the corporate entity. This Wisconsin has done.

Exxon claims that Wisconsin is guilty of "overreach" because it includes as apportionable unitary income a portion of the income which Exxon, through its separate accounting analysis, has attributed to exploration and production activities. Again, Exxon's separate accounting analysis is inconsistent with the unitary concept. Wisconsin's three-factor apportionment formula taxes unitary business income which results from Exxon's total operation beginning with exploration and production activities and ending in sales.

Exxon's separate functional accounting does not establish that Wisconsin is taxing extraterritorial values in violation of the Due Process Clause. Income generated from

Exxon's exploration and production activities is income from a unitary business. Thus, in *Bass, Ratcliff & Gretton v. State Tax Commission*, 266 U.S. 271 (1924), this Court held that a manufacturing and sales corporation was a unitary business and earned no profits prior to the actual sale of its products,[9] saying:

> So in the present case we are of opinion that, as the Company carried on the unitary business of manufacturing and selling ale, in which its profits were earned by a series of transactions, beginning with the manufacture in England and ending in sales in New York and other places,--the process of manufacturing resulting in no profits until it ends in sales,--the state was justified in attributing to New York a just proportion of the profits earned by the company from such unitary business. (266 U.S. at 282).

The fact that Exxon, in order to compute divisional income, places a value on internal transfers of crude oil from its production to refining departments does not mean that Exxon has derived income as a result of such transfers. For income tax purposes Exxon has sold nothing; it has neither realized nor derived any income. It has merely made

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9 Exxon suggests that its operation is different from a manufacturing and sales business since oil and gas exploration and production activities are uniquely associated with a particular state. The Appellee submits that such a distinction is without merit. A manufacturing and sales business manufactures a product for its sales operation; Exxon extracts and refines oil for the same purpose.

an accounting adjustment to account for an internal transfer of goods.[10]

The South Carolina Supreme Court, in *Exxon Corp., supra*, rejected Exxon's claim that the income of its exploration and production departments could be computed on the basis of transfer prices rather than on actual sales to third parties. The court held that a unitary business earned no profits until actual sales of its products were made, *citing Bass, Ratcliff* and a case from the Georgia Court of Appeals. *Phillips v. Sinclair Refining Co.*, 76 Ga. App. 34, 44 S.E.2d 671 (1947).

Exxon suggests that the Wisconsin Supreme Court did not follow its own decisions in two earlier cases when it permitted Appellee to apportion income resulting from oil produced by Exxon and transferred by it to its refining operations. *Standard Oil Co. v. Wisconsin Tax Comm.*, 197 Wis. 630, 223 N.W. 85 (1929); *Kansas City Star Co. v. Department of Taxation*, 8 Wis. 2d 441, 99 N.W.2d 718 (1959).

The *Standard Oil* case was effectively reversed by a 1949 amendment to the Wisconsin statutes wherein the Wisconsin Legislature specifically rejected the separate accounting approach as a method of apportioning the income of a unitary business. *See Celon Co. v. Department of Taxation*, 269 Wis. 372, 376-77, 69 N.W. 453 (1955), wherein the Wisconsin court, referring to a report of the Wisconsin Legislative Council, explained the effect of that amendment.

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10 As indicated in footnote 6, such an accounting procedure, referred to as functional profitability independence, is used by nearly all unitary businesses. It is obviously a valid and valuable accounting tool, but it does not result in the creation of income (or loss) without a sale.

The *Kansas City Star* case did not involve the issue of separate accounting versus apportionment as the parties had previously agreed that separate accounting was the method to be used. The unitary business theory incorporated into Wis. Stats. § 71.07 (2) by the 1949 amendment was not invoked because the bulk of the tax assessed related to income years which preceded such amendment.

The Wisconsin Supreme Court in deciding the *Exxon* case recognized that under formula apportionment there is no necessity for readjusting price and other relationships among divisions within a single unitary corporation. As Mr. Keesling pointed out in his testimony before the Wisconsin Tax Appeals Commission, "I am of the opinion that in the case of a unitary business the prices at which goods transfer from one division to another is irrelevant." (A. 585).

The Appellee submits that while its formulary apportionment approach to Exxon's business does not necessarily identify the precise geographical source of income, it is a reasonable, if not the best possible, method of apportioning income from a unitary business.[11] Wisconsin is not taxing extraterritorial values when it subjects a portion of Exxon's exploration and production income to apportionment; it is taxing income from a unitary business doing business in the state. Such income has a clear and "rational relationship" to Wisconsin.

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11 "This Court in *Moorman* rejected the claim that the Constitution invalidates an apportionment formula whenever the formula might result in taxation of some income which did not have its source in the taxing state. The Court recognized the imprecision of a formulary approach but stated: 'Yet despite this imprecision, the Court has refused to impose strict constitutional restraints on a State's selection of a particular formula.' " (437 U.S. at 273).

B. The separate accounting analysis employed by Exxon does not support the claim that Wisconsin has taxed income with no rational relationship to the state or that it has taxed "a percentage of income out of all appropriate proportion" to the business transacted by Exxon in Wisconsin.

The Appellee contends that separate accounting is incompatible with the concept of the unitary business and cannot, under the *Moorman* decision or any other decision of this Court, be used to impeach the results of Wisconsin's three-factor apportionment formula. (*See*, Part I, B of this brief). However, even if we assume that separate accounting may be used to impeach Wisconsin's formula, Exxon's separate accounting analysis does not prove that Wisconsin has extended its taxing power beyond constitutional limitations. That analysis does not supply the proof which Exxon suggests was lacking in *Moorman*,[12] *Butler Brothers, and Bass, Ratcliff*.

Exxon's separate accounting analysis is incomplete. It fails to account for a single dollar of income on a geographical basis. Thus, for each of the years in question, although Exxon shows a loss in Wisconsin, it fails to show in which jurisdiction or jurisdictions any of its hundreds of million dollars of annual income belongs. Obviously Exxon cannot have a loss in every state. The equation is incomplete since the parts do not equal the whole.

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12 It is interesting to note that under the Iowa single-factor sales formula which was sustained in *Moorman*, the State of Wisconsin's tax during the period at issue would be almost doubled. (Exhibit 35, A. 799).

The unitary concept grew out of the realization that income from a unitary business could not be rationally attributed to particular functions or precisely determined according to taxing jurisdictions. The income from such a business could only be attributed to the business as a whole and not to its various parts. If Exxon is to prove otherwise, it cannot do so by separately accounting only for the State of Wisconsin.[13] If Exxon wants to attempt to separately account for its income on such a basis, it must account for 100 per cent of its income. Wisconsin and other taxing jurisdictions cannot be expected to rebut the piecemeal approach used by Exxon in this case.

III. Subjecting Income From Exxon's Exploration And Production Operations To Apportionment Does Not Violate The Commerce Clause Of Article One Of The United States Constitution.

The taxation by Wisconsin of income generated from Exxon's exploration and production activities does not contravene the Commerce Clause. Exxon cannot show that the tax discriminates against interstate commerce or that it creates an undue burden on such commerce. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). As pointed out by the Wisconsin Supreme Court, Wisconsin can hardly be accused of reaching beyond the limits of constitutional mandates in view of the fact that Wisconsin's assessment of taxable income for the period in question represented only 22/100 of one percent of total company income, and for the same period Wisconsin sales constituted only 41/100 of one percent of total company sales. (90 Wis. 2d at 729, 281 N.W.2d at 110).

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13 This is exactly what the Appellant attempted to do for the tax years in question. (Exhibits 11-7A-11-7D, A. 636-719).

Exxon's Commerce Clause argument is based solely on its assertion that the Constitution prohibits even the risk or possibility of multiple taxation.[14] This Court has not applied such a standard. Thus, in *Moorman* it was pointed out that the Commerce Clause does not prohibit some overlap in the computation of taxable income. After stressing the fact that the Iowa taxpayer had not established the essential factual predicate for a claim of duplicative taxation since on the record its existence was merely "speculative," this Court stated:

> The only conceivable constitutional basis for invalidating the Iowa statute would be that the Commerce Clause prohibits any overlap in the computation of taxable income by the States. If the Constitution were read to mandate such precision in interstate taxation, the consequences would extend far beyond this particular case. For some risk of duplicative taxation exists whenever the States in which a corporation does business do not follow identical rules for the division of income. Accepting appellant's view of the Constitution, therefore, would require extensive judicial lawmaking. Its logic is not limited to a prohibition on use of a single-factor apportionment formula. The asserted constitutional flaw in

14 Exxon does not claim to have shown that actual multiple taxation exists. The Wisconsin court, quoting from *Moorman*, indicated that there was no evidence in the record that Exxon was taxed on more than 100% of its total net income. (90 Wis. 2d at 729, 281 N.W.2d at 110).

> that formula is that it is different from that presently employed by a majority of States and that difference creates a risk of duplicative taxation. But a host of other division-of-income problems create precisely the same risk and would similarly rise to constitutional proportions. (437 U.S. at 278).

The Court stated further: "Finally, it would be an exercise in formalism to declare appellant's income tax assessment unconstitutional based on speculative concerns with multiple taxation." (47 U.S. at 280).

In *First Federal S. & L. v. Mass. Tax Comm'n*, 437 U.S. 255 (1978), handed down the same day as *Moorman*, the taxpayer's multiple risk argument was disposed of in a footnote:

> The federal associations also argue that the state statute violates the Commerce Clause by creating a risk of multiple taxation. They claim that some neighboring State may at some time in the future attempt to tax the income from loans secured by property in that State. This argument is wholly speculative and unsupported by evidence in the record. (437 U.S. at 262).

In both *General Motors Corp. v. Washington*, 377 U.S. 436 (1964), and *Standard Pressed Steel Co. v. Dept. of Revenue of Washington*, 419 U.S. 560 (1975), the Court declined to find any burden of multiple taxation absent an actual showing. As pointed out in the *General*

Motors decision: "[I]t has not been shown that Oregon levies any tax on appellant's activity bearing on Washington sales. In such cases we have refrained from passing on the question of 'multiple taxation.' " (377 U.S. at 449).

The record in the instant case will not sustain Exxon's multiple taxation argument. In addition, the State of Wisconsin has not, by including a portion of the income generated from Exxon's exploration and production operations in its apportionment formula, created any real risk of multiple taxation.[15] Nor will reference to exploration and production income as situs income change this result. This Court long ago in *Adams Express Company v. Ohio*, 165 U.S. 194 (1896), *reh. denied*, 166 U.S. 185 (1897), disposed of Exxon's situs claim, saying:

> In conclusion, let us say that this is eminently a practical age; that courts must recognize things as they are and as possessing a value which is accorded to them in the markets of the world, and that no finespun theories about situs should interfere to enable these large corporations, whose business is carried on through many States, to escape from bearing in each State such burden of taxation as a fair distribution of the actual value of their property among those States requires. (166 U.S. at 225).

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15 Not only is the three-factor formula designed to prevent the risk of multiple taxation, but its use by 44 of the 45 states which impose corporate income taxes should go far to eliminate the potential for such risk. (*See*, footnote 4).

Subjecting a portion of Exxon's income resulting from Exxon's exploration and production operations to apportionment as income from a unitary business does not violate the Commerce Clause.

CONCLUSION

Wherefore, the Appellee respectfully submits that this Court should affirm the decision of the Wisconsin Supreme Court.

Respectfully submitted,

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